



August 3rd, 2020

Polymakers still Needed

- **Polymakers are likely to remain heavily engaged in support of their economies**
- **Stuttering of global growth encourages additional support**
- **US Congress will have to provide, with the Fed as a backstop**
- **Strong markets in July led by precious metals**
- **We believe that both equities and credit remain biased higher**
- **Hold onto your precious metals exposure it's an important insurance policy**

The global economy still needs the active support of governments and central bankers. Last week saw a good deal of data showing how bad the downdraft of economic activity had been. GDP Data in both the US and Europe was as bad as it felt at the time. The US economy contracted by 32.9% in the second quarter at an annualised rate (ar), the eurozone contracted by 40.3% (ar). The economists have pencilled in a sharp recovery in the third quarter, but signs of re-acceleration of the virus cases will keep the polymakers heavily engaged in support of their respective economies

While things have certainly got better, polymakers remain concerned about the economic impact of fresh waves of COVID-19. In the US, Congress has struggled to bring a new package to replace part of the last fiscal package that so significantly boosted income to offset the loss of wage income. Analysis by JPMorgan shows that last quarter, US households lost a record \$795bn (annualised rate) in labour income. However, total disposable income soared over \$1.5tn (annualised rate) in 2Q20 owing to \$2.3tn in policy supports. We have to believe that Congress will eventually agree to a new boost to household incomes. To not do so would likely lead to a severe immediate setback in consumer spending.

With or without a fiscal boost, the US Federal Reserve appears ready to provide ongoing and maybe enhanced support for the economy. Last week's US Federal Reserve meeting statement and press conference implied that they remain fully engaged in supporting the economy and that they may need to take further action at their meeting in September.

Even in China, where the recovery in economic growth has been more consistent, the government is still showing its support. At the Politburo meeting on July 30th the government indicated continuity of economic policy with an explicit statement with regards to the ongoing. The market also still anticipates that the PBOC will cut interest rates further in the coming months.

The less than transparent outlook for growth and the consequent support from policy makers is likely to keep the risk asset markets humming. **We expect equities and bonds to at the very least hold their recent gains.**

July had a silver lining

And the winner is.... silver. Silver was the strongest performing asset class through July with an extraordinary return of 34%. Gold was left in its wake although showing an impressive return of 10.9%. Other asset classes struggled to keep pace with precious metals, although Chinese equities with a gain of 10.9% were up there with gold. Developed market equities returned 4.7% underperforming emerging markets which were up 8.4% led by that strong

performance from China. Other emerging markets did chip in; the Sensex Indian index was up 7.7% and Brazil up 8.3%. Another strong performance from the tech sector led developed market equities higher (+4.7%). The NASDAQ index was up 6.8% ending just shy of its all-time high set mid-month. As the month ended the lifetime low US 10-year yield of 53bps certainly helped growth stocks rally.

The weakness of the dollar was a feature of the month. The dollar trade-weighted index was down 4% for the month. Against the euro, the dollar fell by 4.8%. Under the weight of stronger currencies, non-US equities struggled to give positive returns in local currency terms. The UK equity market fell 4.4% but saw sterling appreciated 5.5% against the dollar.

July saw additional gains for credit indices, across the board. Leading the way was the investment-grade markets but followed closely by all the other key markets in high yield and emerging market bonds. In all cases, the returns for investors were in the region of 1.5% to 3%, depending on the market. Year-to-date, the gains for Investment Grade (IG) bonds is now 8.2% (ICE/BOFA Index). The riskier parts of the bond markets are still down for the year, on balance, but only marginally so. Another firm month will see the entire credit universe back in the black and set to likely deliver returns in line with the average of recent times.

In spread terms – the gap between the yield on credit bonds compared to the yield on government bonds of the same duration – the market has been narrowing as well. However, **it is notable that credit, even at the strongly performing IG level, is lagging the total returns of the government bond market.** For all the power of the relief rally, duration has still been a better bet than credit. The tightening in spreads continued in July, as IG spreads narrowed by 20 basis points, and high yield came in by 128 basis points. Interestingly, the worst part of the spectrum, CCC-rated bonds, saw spreads tighten by as much as 174 basis points. This is somewhat surprising given the well-telegraphed intention of the major rating agencies to keep downgrading stressed credits, coupled with clear evidence of escalating default rates in the nether regions of the credit market. Moody's estimates a current default rate of around 7%, and an increase to 11% or more, on an annualised basis, by Q4.

The context is perhaps understandable. The Fed will be extending support to the credit market until the end of 2020, at the least. While the support does not explicitly extent down to the CCC level, even the relatively modest amount of purchasing done to date seems to have been sufficient to support risk appetite in the market. And let it not be overlooked that a torrid spell preceded the summer sunshine for this part of the market in the prior months. CCC's are running a whopping 16% behind government bonds on a year-to-date basis.

Apart from an improved risk sentiment, two additional factors are supportive of tightening credit spreads. First, in both the UK and the European Union, the regulators have signalled to banks that they should remain in cash-conservation mode until at least the end of the year. That is to say, don't pay any dividends. The ECB has just concluded a vulnerability analysis (stress test) using a central case and an adverse case, testing to see what impact it has on the largest banks in the supervision universe. In the base case, the aggregate Common Equity Tier 1 (CET1) ratio drops from 14.5% at the start of this year to 12.6% in 2022. This is manageable. In the more stressed scenario, the drop is much more significant, down to 8.8% over the same period. The testing included the impact of the announced stimulus measures. However, it did not include an effect described as risk-weighted asset migration: the impact of downgrades to the credit quality of the balance sheet and the need to raise capital to repair the potential damage.

Second, after the issuance binge of the last few months, July saw more muted issuance of new bonds. Stronger credits out there will have already raised significant fresh funding. Milder supply and the need for yield would have helped to underpin strong performance.

Be wary of taking profits in gold and silver; they still have a precious role to play

The significant rise in precious metals prices understandably has many investors itching to take some profits. We are more minded to staying with the asset class. Technically speaking there is room for a setback given the almost exponential rise seen in recent trading sessions. Technical analysts suggest that given that gold has failed to break the \$1982 level there may be some consolidation before any further increase. However, we believe that many investors are increasingly aware that there are very few liquid assets that afford the investor protection from new waves of COVID19. Any lockdowns would bring downgrades to GDP forecasts and the risk of further significant

increases in government spending with consequent central bank quantitative easing. We are also cognisant that investors worry that on the day that an effective vaccine is found the gold price is likely to be down not up. **Our advice – think of gold as your insurance policy you have to pay the price for keeping safe and financially secure. Most other assets will take care of your upside.**

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